TREX CO INC
Form 10-Q
November 04, 2010
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UNITED STATES

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the quarterly period ended September 30, 2010

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

For the transition period from to

Commission File Number: 001-14649

Trex Company, Inc.

(Exact name of registrant as specified in its charter)

Delaware	**54-1910453**
(State or other jurisdiction of incorporation or organization)	**(I.R.S. Employer Identification No.)**
160 Exeter Drive Winchester, Virginia	**22603-8605**
(Address of principal executive offices)	**(Zip Code)**

Registrant s telephone number, including area code: (540) 542-6300

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant has submitted electronically and posted on its corporate Web site, if any, every Interactive Data File required to be submitted and posted pursuant to Rule 405 of Regulation S-T during the preceding 12 months (or for such shorter period that the registrant was required to submit and post such files). Yes ¨ No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, a non-accelerated filer, or a smaller reporting company. See the definitions of large accelerated filer, accelerated filer and smaller reporting company in Rule 12b-2 of the Exchange Act.:

Large accelerated filer	¨	Accelerated filer	x
Non-accelerated filer	¨	Smaller reporting company	¨

Indicate by check mark whether the registrant is a shell company (as defined by Rule 12b-2 of the Exchange Act): Yes ¨ No x

The number of shares of the registrant s common stock, par value $.01 per share, outstanding at November 3, 2010 was 15,456,760 shares.

TREX COMPANY, INC.

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PART I

FINANCIAL INFORMATION

Item 1. Financial Statements

TREX COMPANY, INC.

Condensed Consolidated Balance Sheets

(In thousands)

	December 31, 2009	September 30, 2010 (Unaudited)
Assets		
Current assets:		
Cash and cash equivalents	$ 19,514	$ 43,150
Accounts receivable, net	31,429	13,028
Inventories, net	45,485	57,228
Prepaid expenses and other assets	2,368	1,825
Income taxes receivable	7,775	78
Total current assets	106,571	115,309
Property, plant, and equipment, net	137,027	127,834
Goodwill	6,837	6,837
Other assets	6,024	2,198
Total assets	$ 256,459	$ 252,178
Liabilities and Stockholders Equity		
Current liabilities:		
Accounts payable	$ 16,514	$ 11,243
Accrued expenses	19,126	20,996
Accrued warranty	9,256	5,893
Deferred income taxes	485	485
Current portion of long-term debt	545	579
Total current liabilities	45,926	39,196
Deferred income taxes	1,925	1,925
Accrued taxes	3,735	2,803
Non-current accrued warranty	2,268	6,017
Debt-related derivative	392	366
Long-term debt	76,634	82,219
Total liabilities	130,880	132,526
Stockholders equity:		

Preferred stock, $0.01 par value, 3,000,000 shares authorized; none issued and outstanding				
Common stock, $0.01 par value, 40,000,000 shares authorized; 15,397,093 and 15,456,632 shares issued and outstanding at December 31, 2009 and September 30, 2010, respectively		154		155
Additional paid in capital		96,197		97,983
Accumulated other comprehensive loss		(265)		(239)
Retained earnings		29,493		21,753
Total stockholders equity		125,579		119,652
Total liabilities and stockholders equity	$	256,459	$	252,178

See Accompanying Notes to Condensed Consolidated

Financial Statements (Unaudited).

1

TREX COMPANY, INC.

Condensed Consolidated Statements of Operations

(Unaudited)

(In thousands, except share and per share data)

	Three Months Ended September 30, 2009	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2010
Net sales	$ 61,949	$ 60,579	$ 221,054	$ 242,418
Cost of sales	43,467	51,305	157,257	186,341
Gross profit	18,482	9,274	63,797	56,077
Selling, general and administrative expenses	13,964	14,024	47,937	52,305
Impairment of long-lived assets	23,251		23,251	
Income (loss) from operations	(18,733)	(4,750)	(7,391)	3,772
Interest expense, net	3,930	3,907	11,012	11,577
Loss before income taxes	(22,663)	(8,657)	(18,403)	(7,805)
Provision (benefit) for income taxes	(201)	69	(203)	(65)
Net loss	$ (22,462)	$ (8,726)	$ (18,200)	$ (7,740)
Basic loss per common share	$ (1.49)	$ (0.57)	$ (1.21)	$ (0.51)
Basic weighted average common shares outstanding	15,082,047	15,206,561	15,048,467	15,179,618
Diluted loss per common share	$ (1.49)	$ (0.57)	$ (1.21)	$ (0.51)
Diluted weighted average common shares outstanding	15,082,047	15,206,561	15,048,467	15,179,618

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TREX COMPANY, INC.

Condensed Consolidated Statements of Cash Flows

(unaudited)

(In thousands)

	Nine Months Ended September 30,	
	2009	**2010**
Operating Activities		
Net loss	$ (18,200)	$ (7,740)
Adjustments to reconcile net income to net cash used in operating activities:		
Depreciation and amortization	18,776	15,995
Debt discount amortization	5,050	6,022
Impairment of long-lived assets	23,251	
Equity method losses	141	1,224
Derivatives	(827)	
Stock-based compensation	2,687	2,755
Loss on disposal of property, plant and equipment	29	264
Changes in operating assets and liabilities:		
Accounts receivable	(1,406)	18,360
Inventories	31,721	(11,743)
Prepaid expenses and other assets	3,337	2,226
Accounts payable	(5,187)	(5,271)
Accrued expenses	(13,945)	1,149
Income taxes receivable	2,353	7,873
Net cash provided by operating activities	47,780	31,114
Investing Activities		
Expenditures for property, plant and equipment	(5,022)	(6,263)
Proceeds from sales of property, plant and equipment	45	85
Notes receivable, net	72	73
Net cash used in investing activities	(4,905)	(6,105)
Financing Activities		
Financing costs	(7)	
Principal payments under mortgages and notes	(25,963)	(404)
Borrowings under line of credit		44,000
Principal payments under line of credit		(44,000)
Repurchases of common stock	(571)	(1,156)
Proceeds from employee stock purchase and option plans	268	187
Net cash used in financing activities	(26,273)	(1,373)
Net increase in cash and cash equivalents	16,602	23,636
Cash and cash equivalents at beginning of period	23,189	19,514
Cash and cash equivalents at end of period	$ 39,791	$ 43,150

Supplemental Disclosure:				
Cash paid (received) during the period for:				
Interest, net of amounts capitalized	$	6,842	$	6,430
Income taxes, net of refunds received	$	(2,310)	$	(7,590)

See Accompanying Notes to Condensed Consolidated

Financial Statements (Unaudited).

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TREX COMPANY, INC.

Notes to Condensed Consolidated Financial Statements

For the Nine Months Ended September 30, 2009 and 2010

(unaudited)

1. BUSINESS AND ORGANIZATION

Trex Company, Inc. (the Company) is the country s largest manufacturer of wood-alternative decking, railing, fencing and trim products, which are marketed under the brand name Trex®. We are incorporated in Delaware. Our principal executive offices are located at 160 Exeter Drive, Winchester, Virginia 22603, and our telephone number at that address is (540) 542-6300. The Company operates in one business segment.

2. BASIS OF PRESENTATION

The accompanying unaudited condensed consolidated financial statements have been prepared in accordance with accounting principles generally accepted in the United States for interim financial information and the instructions to Form 10-Q and Article 10 of Regulation S-X. Accordingly, the accompanying condensed consolidated financial statements do not include all of the information and footnotes required by accounting principles generally accepted in the United States for complete financial statements. In the opinion of management, all adjustments (consisting of normal and recurring adjustments) considered necessary for a fair presentation have been included in the accompanying condensed consolidated financial statements. The consolidated results of operations for the nine months ended September 30, 2010 are not necessarily indicative of the results that may be expected for the full fiscal year. These condensed consolidated financial statements should be read in conjunction with the audited consolidated financial statements as of December 31, 2008 and 2009 and for each of the three years in the period ended December 31, 2009 included in the annual report of Trex Company, Inc. on Form 10-K, as filed with the Securities and Exchange Commission.

The Company consolidates its wholly-owned subsidiary, Trex Wood-Polymer Espana, S.L., which owns a 35% equity interest in Denplax, S.A., a Spanish joint venture formed to recycle polyethylene at a facility in El Ejido, Spain. The Company s investment in Denplax is accounted for using the equity method. In addition, the Company has an outstanding note due from Denplax. At December 31, 2009, the amount of the Company s investment in Denplax and note due from Denplax was $1.2 million and $1.6 million, respectively. At June 30, 2010, the amount of the Company s investment in Denplax and note due from Denplax was $1.0 million and $1.4 million, respectively. During the three months ended June 30, 2010, the Company determined that it would end its purchasing relationship with Denplax and begin to domestically source its requirements with higher quality material at a lower cost. Consequently, at June 30, 2010, based on these developments and an analysis of the financial performance and position of Denplax, the Company determined that the amount of the investment in Denplax and note due from Denplax were not recoverable and recorded a $2.4 million charge to earnings to reduce the carrying amount of the equity investment and note related to Denplax. As of September 30, 2010, the investment in Denplax and the note due from Denplax remain fully reserved.

The Company s critical accounting policies are included in the Company s Annual Report of Form 10-K for the year ended December 31, 2009.

3. NEW ACCOUNTING STANDARDS

Accounting Pronouncements Recently Adopted

In June 2009, the FASB issued a pronouncement, now codified within ASC 810-10, (formerly SFAS No. 167, *Amendments to FASB Interpretation No. 46(R)*, *Consolidation of Variable Interest Entities).* This updated guidance requires an analysis to determine whether a variable interest gives the entity a controlling financial interest in a variable interest entity. The determination of whether a reporting entity is required to consolidate another entity is based on, among other things, the other entity s purpose and design and the reporting entity s ability to direct the activities of the other entity that most significantly impact the other entity s economic performance. ASC 810-10 will require a reporting entity to provide additional disclosures about its involvement with variable interest entities and any significant changes in risk exposure due to that involvement. A reporting entity will be required to disclose how its involvement with a variable interest entity affects the reporting entity s financial statements. The Company adopted ASC 810-10 effective January 1, 2010. The adoption of ASC 810-10 had no impact on the Company s results of operations or financial position.

In January 2010, the FASB issued Accounting Standard Update No. 2010-06, Fair Value Measurements and Disclosures (Topic 820) Improving Disclosures about Fair Value Measurements (ASU No. 2010-06). This update requires additional disclosures about (1) the different classes of assets and liabilities measured at fair value, (2) the valuation techniques and inputs used, (3) the activity in Level 3 fair value measurements, and (4) the transfers between Levels 1, 2, and 3. ASU No. 2010-06 is effective for interim and annual reporting periods beginning after December 15, 2009. The Company adopted

ASU 2010-06 effective January 1, 2010. The adoption had no impact on the Company s results of operations or financial position.

4. COMPREHENSIVE INCOME (LOSS)

The Company s comprehensive loss was ($22.5) million and ($8.7) million for the three months ended September 30, 2009 and 2010, respectively and ($17.9) million and ($7.7) million for the nine months ended September 30, 2009 and 2010, respectively. Comprehensive income (loss) consists of net income (loss) and net unrealized gains and losses on debt-related derivatives, net of tax.

5. INVENTORIES

Inventories, at LIFO (last-in, first-out) value, consist of the following (in thousands):

	December 31, 2009	September 30, 2010
Finished goods	$ 25,846	$ 34,683
Raw materials	19,639	22,545
Total inventories	$ 45,485	$ 57,228

Due to the liquidation of certain inventories, a portion of the Company s cost of sales is based on prior years costs rather than current year costs. As a result, the Company recognized benefits of $0.1 million and $1.8 million during the three and nine months ended September 30, 2010, respectively, compared to benefits of $9.1 million and $9.2 million during the three and nine months ended September 30, 2009, respectively.

During the three months ended September 30, 2009, management decided to reclaim for future use in its manufacturing process certain finished goods inventories that are no longer saleable or do not meet quality specifications. As a result, the Company recorded a charge of $7.2 million in the three months ended September 30, 2009. This charge gave rise to $7.4 million of the aforementioned $9.1 million LIFO benefit recognized in the three months ended September 30, 2009. Without the effect of the inventory reclamation, the benefit recognized as a result of the liquidation of certain inventories during the three and nine months ended September 30, 2009 would have been $1.7 million and $1.8 million, respectively, compared to benefits of $0.1 million and $1.8 million during the three and nine months ended September 30, 2010, respectively.

An actual valuation of inventory under the LIFO method can be made only at the end of each year based on the inventory levels and costs at that time. Accordingly, interim LIFO calculations are based on management s estimates of expected year-end inventory levels and costs. Since inventory levels and costs are subject to factors beyond management s control, interim results are subject to the final year-end LIFO inventory valuation.

6. ACCRUED EXPENSES

Accrued expenses consist of the following (in thousands):

	December 31, 2009	September 30, 2010
Accrued compensation and benefits	$ 5,917	$ 4,324
Accrued interest	3,850	2,233
Accrued rent obligations	2,351	2,119
Accrued sales and marketing	2,536	2,658
Accrued taxes and penalties	278	379
Other	4,194	9,283
Total accrued expenses	$ 19,126	$ 20,996

7. DEBT

Long-term debt consists of the following (in thousands):

	December 31, 2009	September 30, 2010
Real estate loan	$ 3,086	$ 2,683
Convertible notes	97,500	97,500
	100,586	100,183
Less unamortized debt discount	(23,407)	(17,385)
	77,179	82,798
Less current portion	(545)	(579)
Total long-term debt	$ 76,634	$ 82,219

The Company s outstanding debt consists of a real estate loan, convertible bond notes and a revolving credit facility. At September 30, 2010, the Company had no outstanding borrowings under its revolving credit facility and an available borrowing capacity of $54.9 million.

As of September 30, 2010 the Company was in compliance with all of the covenants contained in its debt agreements. Failure to comply with our loan covenants might cause our lenders to accelerate our repayment obligations under our credit facility, which may be declared payable immediately based on a default and which could result in a cross-default under our $97.5 million principal amount of outstanding convertible notes.

The following table provides additional information regarding the Company s convertible debt instruments that are subject to ASC 470 (in thousands, except conversion price):

	December 31, 2009	September 30, 2010
Principal amount of the liability component	$ 97,500	$ 97,500
Unamortized discount of liability component	(23,407)	(17,385)
Net carrying amount of liability component	74,093	80,115
Carrying amount of the equity component	23,860	23,860
Remaining amortization period of discount	30 months	21 months
Conversion price	$ 21.78	$ 21.78
Effective interest rate on liability component	18.41%	18.41%
If-converted value in excess of principal amount (a)		
If-converted number of shares to be issued (a)		

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2010	2009	2010
Interest expense at coupon rate (6.0%)	$ 1,462	$ 1,462	$ 4,387	$ 4,387
Non-cash interest in accordance with ASC 470	1,783	2,127	5,050	6,022

(a) If-converted value amounts are for disclosure purposes only. The notes are convertible when the closing price of the Company s common stock for at least 20 trading days in the 30 consecutive trading days ending on the last trading day of the preceding fiscal quarter is greater than or equal to $28.31 (130% of the conversion price) on each applicable trading day. The principal amount of the notes is settled in cash upon conversion. The value of the notes in excess of the principal amount is settled in common shares upon conversion. Based upon the Company s stock prices during the three months ended September 30, 2010, the notes are not currently convertible. The if-converted value in excess of the principal amount and the if converted number of shares to be issued illustrated above are based on the average stock price of $20.63 during the three months ended September 30, 2010, which fell below the conversion price of $21.78.

8. FAIR VALUE MEASUREMENT

The Company adopted certain provisions of FASB ASC Topic 820 on January 1, 2008, which defines fair value, establishes a framework for measuring fair value in accordance with generally accepted accounting principles and expands disclosures about fair value measurements.

ASC 820 requires the categorization of financial assets and liabilities based upon the level of judgments associated with the inputs used to measure their fair value. Hierarchical levels, defined by ASC 820 and directly related to the amount of subjectivity associated with the inputs used to determine the fair value of financial assets and liabilities, are as follows:

Level 1 Inputs are unadjusted, quoted prices in active markets for identical assets or liabilities at the measurement date

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Level 2 Inputs (other than quoted prices included in Level 1) are either directly or indirectly observable for the assets or liability through correlation with market data at the measurement date and for the duration of the instrument s anticipated life

Level 3 Inputs reflect management s best estimate of what market participants would use in pricing the asset or liability at the measurement date. Consideration is given to the risk inherent in the valuation technique and the risk inherent in the inputs to the model.

The following table presents the financial assets and liabilities measured at fair value on a recurring basis, based on the fair value hierarchy as of September 30, 2010 (in thousands):

	Total Fair Value Measurement September 30, 2010	Quoted Prices in Active Markets for Identical Asset (Level 1)	Significant Other Observable Inputs (Level 2)	Significant Unobservable Inputs (Level 3)
Debt-related derivative liability	$ 366	$	$ 366	$

The Company uses interest-rate swap contracts to manage its exposure to fluctuations in the interest rates under its variable-rate real estate loan.

9. FINANCIAL INSTRUMENTS

The Company considers the recorded value of its financial assets and liabilities, consisting primarily of cash and cash equivalents, accounts receivable, accounts payable, accrued expenses and other current liabilities, and real estate loans to approximate the fair value of the respective assets and liabilities at December 31, 2009 and September 30, 2010. At September 30, 2010, the fair value of the Company s 6.00% Convertible Senior Subordinated Notes due 2012 was estimated at $105.3 million based on quoted market prices.

The Company uses interest rate swap contracts to manage its exposure to fluctuations in the interest rates under its variable-rate real estate loan. At September 30, 2010, the Company had one fixed-for-floating interest rate swap that matures on October 1, 2014, which effectively converts the Company s variable-rate real estate loan to a fixed-rate obligation. The Company accounts for interest rate swaps as derivative instruments in accordance with FASB ASC Topic 815, *Derivatives and Hedging* (formerly SFAS No. 133, *Accounting for Derivative Instruments and Hedging Activities,* as amended). ASC 815 requires derivative instruments to be measured at fair value in the condensed consolidated balance sheets. At September 30, 2010 the fair value of the Company s interest rate swap was $0.4 million and was classified as a long-term liability in the accompanying condensed consolidated balance sheets. The interest rate swap instrument qualifies for, and was designated as, a cash flow hedge of a forecasted transaction in accordance with ASC 815 and the change in fair value of this instrument was recorded, net of tax, in Accumulated other comprehensive loss in the accompanying consolidated balance sheets. At September 30, 2010, $0.2 million of unrealized losses, net of tax, were recorded in Accumulated other comprehensive loss in the accompanying consolidated balance sheets. The Company expects approximately $0.2 million to be reclassified into Interest expense, net over the next twelve months.

The following table illustrates the changes in Accumulated other comprehensive loss related to the cash flow hedge during the nine months ended September 30, 2010 (in thousands):

	Fair Value of Cash Flow Hedges	Tax Effect	Fair Value of Cash Flow Hedges, Net of Tax
Balance, December 31, 2009	$ 392	$ (127)	$ 265
Gain (loss) reclassified to interest expense, net	(142)		(142)
Unrealized (gains) losses during period	116		116
Balance, September 30, 2010	$ 366	$ (127)	$ 239

10. EARNINGS PER SHARE

The following table sets forth the computation of basic and diluted earnings per share (in thousands, except share and per share data):

	Three Months Ended September 30, 2009	Three Months Ended September 30, 2010	Nine Months Ended September 30, 2009	Nine Months Ended September 30, 2010
Numerator:				
Net loss available to common shareholders	$ (22,462)	$ (8,726)	$ (18,200)	$ (7,740)
Denominator:				
Basic weighted average shares outstanding	15,082,047	15,206,561	15,048,467	15,179,618
Effect of dilutive securities: SARs and options				
Convertible notes				
Restricted stock				
Diluted weighted average shares outstanding	15,082,047	15,206,561	15,048,467	15,179,618
Basic loss per share	$ (1.49)	$ (0.57)	$ (1.21)	$ (0.51)
Diluted loss per share	$ (1.49)	$ (0.57)	$ (1.21)	$ (0.51)

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The Company has excluded the dilutive effect of stock options, stock appreciation rights and restricted stock for the three and nine months ended September 30, 2009 and 2010, respectively, due to net operating losses for these periods. The Company also evaluated the dilutive effect of its convertible notes and determined no impact for these periods.

11. STOCK-BASED COMPENSATION

Effective January 1, 2006, the Company adopted the fair value recognition provisions of FASB ASC Topic 718, *Share-Based Payment*, (ASC 718). Under the transition method, compensation cost includes (a) compensation cost for all share-based payments granted prior to, but not yet vested as of, January 1, 2006, based on the grant date fair value estimated in accordance with the original provisions of ASC 718; and (b) compensation cost for all share-based payments granted subsequent to January 1, 2006, based on the grant date fair value estimated in accordance with the provisions of ASC 718.

The Company has one stock-based compensation plan, the 2005 Stock Incentive Plan (the 2005 Plan), which was amended by its shareholders on May 7, 2008. The 2005 Plan is administered by the Compensation Committee of the Company s Board of Directors. Stock-based compensation is granted to officers, directors and certain key employees in accordance with the provisions of the 2005 Plan. The 2005 Plan provides for grants of stock options, share settled stock appreciation rights (SARs), restricted stock and performance share awards. As of September 30, 2010, the total aggregate number of shares of the Company s common stock that may be issued under the 2005 Plan is 3,150,000.

The fair value of each SAR is estimated on the date of grant using a Black-Scholes option-pricing formula. For SARs issued in the nine months ended September 30, 2009 and 2010, respectively, the assumptions shown in the following table were used:

	Nine Months Ended September 30,	
	2009	2010
Weighted-average fair value of grants	$ 6.79	$ 10.27
Dividend yield	0%	0%
Average risk-free interest rate	1.6%	2.6%
Expected term (years)	5	5
Expected volatility	58%	66%

The following table summarizes the Company s stock-based compensation grants for the nine months ended September 30, 2010:

	Stock Awards Granted	Weighted-Average Grant Price Per Share
Stock appreciation rights	136,433	$ 17.94
Restricted stock	91,717	$ 17.41

The following table summarizes the Company s stock-based compensation expense for the three and nine months ended September 30, 2009 and 2010 (in millions):

	Three Months Ended September 30,		Nine Months Ended September 30,	
	2009	2010	2009	2010
Stock appreciation rights	$ 0.6	$ 0.6	$ 1.5	$ 1.5
Restricted stock	0.4	0.4	1.2	1.3
Total stock-based compensation	$ 1.0	$ 1.0	$ 2.7	$ 2.8

Total unrecognized compensation cost related to unvested awards as of September 30, 2010 totaled $4.0 million. The cost of these unvested awards is being recognized over the requisite vesting period of 36 months from date of grant.

12. INCOME TAXES

In accordance with ASC 740, *Income Taxes*, the Company has recorded a valuation allowance against its net deferred tax asset. The effect of maintaining the valuation allowance is to substantially reduce the Company s effective tax rate as the tax expense or benefit recorded at the statutory tax rate is offset by a corresponding expense or benefit resulting from the change in the valuation allowance. Accordingly, the Company s effective tax rate for the nine months ended September 30, 2010 and 2009 was 0.8% and 1.1%, respectively, which resulted in a benefit of $65 thousand and $203 thousand, respectively. The higher 2009 effective tax rate was primarily the result of benefits recognized in the nine months ended September 30, 2009 due to lower than expected tax settlements with various taxing jurisdictions.

The Company operates in multiple tax jurisdictions and, in the normal course of business, its tax returns are subject to examination by various taxing authorities. Such examinations may result in future assessments by these taxing authorities and the Company has accrued a liability when it believes that it is not more likely than not that it will realize the benefits of tax positions that it has taken or for the amount of any tax benefit that exceeds the cumulative probability threshold in accordance with ASC 740. The Company believes that adequate provisions have been made for all tax returns subject to examination. As of September 30, 2010, tax years 2003 through 2009 remain subject to examination by federal and certain state tax jurisdictions. The Internal Revenue Service is currently examining our federal income tax returns for the tax years 2003 through 2008.

The Company has taken tax positions in certain taxing jurisdictions for which it is reasonably possible that the total amounts of unrecognized tax benefits may decrease within the next 12 months. The possible decrease could result from the closing of the statutes for tax purposes in some taxing jurisdictions and would be approximately $0.6 million.

13. SEASONALITY

The Company s operating results have historically varied from quarter to quarter, in part due to seasonal trends in the demand for Trex®. The Company has historically experienced lower net sales during the fourth quarter because holidays and adverse weather conditions in certain regions reduce the level of home improvement and construction activity.

14. COMMITMENTS AND CONTINGENCIES

Contract Termination Costs

As of September 30, 2010, the minimum payments remaining under the Company s lease relating to its reconsidered corporate relocation over the years ending December 31, 2010, 2011, 2012, 2013 and 2014 are $0.4 million, $1.6 million, $1.9 million, $2.0 million and $2.0 million, respectively, and $9.4 million thereafter. The minimum receipts remaining under the Company s existing subleases over the years ending December 31, 2010, 2011, 2012, 2013 and 2014 are $0.4 million, $1.6 million, $1.6 million, $1.3 million and $1.0 million, respectively. The Company accounts for the costs associated with the lease as contract termination costs in accordance with FASB ASC 420, *Exit or Disposal Cost Obligations.* During the three months ended September 30, 2010, the Company entered into an agreement to terminate a portion of the lease. The termination agreement resulted in a $0.2 million termination fee and increase to the Company s liability.

The following table provides information about the Company s liability related to the lease (in thousands):

	2009	2010
Balance as of January 1	$ 524	$ 485
Net cash receipts (payments)	(56)	(164)
Accretion of discount	31	32
Increase (decrease) in estimated contract termination costs		225
Balance as of September 30	$ 499	$ 578

Product Warranty

The Company warrants that its products will be free from material defects in workmanship and material and will not check, split, splinter, rot or suffer structural damage from termites or fungal decay. With respect to the Company s new Transcend product, the Company further warrants that the product will not fade in color more than a certain amount and will be resistant to permanent staining from food substances or mold (provided the stain is cleaned within seven days of appearance). Each of these warranties generally extends for a period of 25 years for residential use and 10 years for commercial use. If there is a breach of such warranties, the Company has an obligation either to replace the defective product or refund the purchase price. The Company establishes warranty reserves to provide for estimated future expenses as a result of product defects that result in claims. Reserve estimates are based on management s judgment, considering such factors as cost per claim, historical experience, anticipated rates of claims, and other available information. Management reviews and adjusts these estimates, if necessary, on a quarterly basis based on the differences between actual experience and historical estimates.

In 2007, the Company recorded a significant increase to its warranty reserve due to a high number of claims resulting from a small percentage of material produced at its Nevada facility that exhibited surface defects. The Company continues to settle these claims against the warranty reserve and regularly monitors the adequacy of the remaining reserve.

During 2010, the Company has experienced an increased trend in the number of warranty claims received. The Company also experienced changes in the nature of warranty claims, including the expected cost to resolve such claims. As a result of these developments, the Company recorded an increase to the warranty reserve of $9.0 million during the three months ended June 30, 2010 and an additional $0.8 million in the three months ended September 30, 2010. Management believes that the increased number of claims received over what the Company expected is primarily the result of the Company s involvement in, and related public announcements about, a recently settled class action suit related to surface flaking of a limited amount of product produced and sold at the Nevada facility prior to the middle of 2006. The settlement of the suit also introduced a new category of claims to provide for partial labor payments for claims that were previously settled with material only. Management anticipates that, beginning in late 2010, the effects of the lawsuit will diminish and the number of claims will substantially decrease to levels expected prior to the lawsuit. If the level of claims does not diminish consistent with the Company s expectations, it could result in additional increases to the warranty reserve and reduced earnings in future periods. The Company estimates that a 10% change in the expected number of remaining claims or the expected cost to settle claims may result in approximately a $1 million change in the warranty reserve.

The following is a reconciliation of the Company s warranty reserve (in thousands):

	2009	2010
Beginning balance, January 1	$ 21,856	$ 11,524
Provision for estimated warranties	250	9,765
Settlements made during the period	(7,770)	(9,379)
Ending balance, September 30	$ 14,336	$ 11,910

Legal Matters

As reported in the Company s Annual Report on Form 10-K for the year ended December 31, 2009, on January 19, 2009, a class action case was commenced against the Company in the Superior Court of California, Santa Cruz County, by the lead law firm of Lieff, Cabraser, Heimann & Bernstein, LLP and certain other law firms (the Lieff Cabr